

Bonds were down and out – now they could beat stocks



ROGER MONTGOMERY
ANALYSIS

Right when many believed bonds were a no-go zone for investment portfolios, they're becoming more attractive.

For more than a decade after the GFC, central banks pushed interest rates to near-zero – and in some places, below zero. This made borrowing almost free, but at the same time it starved savers and bond investors of income.

Then, eventually, after inflation surged and persisted, central banks changed tack, interest rates soared and both bond and equity investors suffered the same fate. Both crashed, with bonds failing to offer the hedge expected in a typical 60/40 portfolio.

Today, the era of artificially lower-than-inflation interest rates, or what's known as "financial repression", is over. Yields on long-term government bonds, such as the US 10-Year Treasury note, have climbed dramatically.

So equity and bond investors are now asking whether interest rates have returned sustainably to levels more typical of long-term history, and whether it's finally time to buy bonds again. The answer to that question also has serious implications for stockmarket investors, because as investors migrate to the "attractive" yields offered by bonds, they sell stocks.

Bond rates

First, a little background as it would be helpful to have some insights into where rates are headed. To understand that, we need to look at what's driving them.

Many analysts argue that irresponsible fiscal policy and spendthrift governments are to blame for high bond rates. The narrative goes something like this: because the US government is running massive budget deficits and issuing vast amounts of debt, nervous investors are demanding a higher return – a penalty known as a "risk premium" – to hold that debt. Yet, some data tells a different story, and there are two ways of testing the counterargument.

First, we can offer an alternative theory: the recent rise in US bond yields may simply reflect robust economic growth. Over long periods, government borrowing costs naturally follow nominal economic growth – which is simply real economic output plus inflation. An economy running on more fuel can easily support higher interest rates. And that's relevant because current US economic growth is mirroring levels not seen since the mid-1980s, naturally pushing expected interest rates higher.

One comparison that supports this argument is China. If US bond yields are high because they are considered unsafe – with everyone fearing fiscal profligacy – then China's yields are low because they're considered "safe". Yet many say China's domestic economy is suffering from sluggish domestic demand and relatively weak growth. So, in the US

yields are high because the economy has grown rapidly. And in China, bond yields are very low – not because Chinese debt is considered safer, but because China's domestic economy is struggling.

The second way to argue the case is to test the "fiscal panic" theory directly. To do this, we need to first break a bond's yield down into its two core components. The 10-year bond yield equals expected future interest rates plus something called the term premium. Expected future interest rates are what investors expect central banks (like the US Federal Reserve) to set as short-term policy rates over the next decade. The term premium is the extra return investors demand as compensation for tying up their money for 10 long years.

If investors were truly panicking about profligate US government spending, the term premium would be sky-high. But estimates suggest the US Treasury term premium sits below zero, with some analysts suggesting negative-50 basis points.

In plain terms, it seems US bond yields are high because expected economic growth and policy rates are high, and the risk premium on US debt is actually unusually low. So, why is the risk premium on US debt negative despite massive government borrowing? The answer is that US Treasuries aren't just a bond for your 60/40 balanced portfolio.

They also serve as the primary collateral for the global financial system. Major banks and global financial institutions use US Treasuries to back trillions of dollars in daily loans, trades, and refinancing operations. So, when global liquidity tightens and credit becomes harder to find, financial stress forces institutions to hoard the safest, most liquid asset: US Treasury bonds. The surge in demand for collateral keeps US bond prices supported.

Implications

Financial markets constantly move through cycles. As the economy shifts from a strong growth phase into a cooler, more turbulent phase, two major forces begin working in favour of bond investors at the exact same time.

As economic growth cools, central banks usually cut short-term interest rates to stimulate activity. This lowers the first component of the bond yield equation. Secondly, as financial conditions tighten, institutional demand for Treasuries as safe collateral remains strong, keeping the second component, the term premium, low or driving it lower.

Bond yields and bond prices move in opposite directions – when yields fall, bond prices rise. In other words, investors lock in a great yield and then make a capital gain as bond prices rise.

Over the past 10 years, bond investors had a raw deal: earning little income and facing market volatility. Today, that equation is shifting: starting yields are respectable, income is predictable, and if economic growth moderates, there might be capital gains, just as stocks could fall.

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